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Supreme Court of the United States

October Term, 1966.

No. 428.

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

UNITED BENEFIT LIFE INSURANCE COMPANY.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit.

BRIEF FOR RESPONDENT.

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SECURITIES AND EXCHANGE COMMISSION,
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UNITED BENEFIT LIFE INSURANCE COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

BRIEF FOR RESPONDENT.*

* Emphasis has been added by using bold face type in all quotations.

QUESTION PRESENTED.[1]

A life insurance company issues a deferred annuity contract (FFA)[2] identical in all essential respects except one with the conventional deferred annuity contract. The obligations of the insurance company in the FFA are stated, as found by the court below, in large part, in terms of guaranteed dollar amounts. The company underwrites: (a) all of the mortality risk over the entire duration of the contract; (b) all of the expense risk over the entire duration of the contract; (c) all of the annuitant's risk of losing principal (sum of the net premiums) over the entire duration of the contract; and (d) all of the annuitant's risk of improvement of principal during the entire income-payment period of the contract. The one respect in which the FFA differs from the conventional deferred annuity is that in the FFA—while the respondent guarantees the amount of principal underlying the contract—there is no guaranteed interest accumulation. In lieu thereof, the re-

1. Petitioner in its Brief has made a significant change in the form of the question. In the Petition the question asserted that in the FFA "the value of the purchaser's interest during the accumulation period and the size of the annuity available at maturity **depend** upon the value of a portfolio of securities." This original formulation was so unquestionably misleading that petitioner has reframed the question in its Brief (p. 2) to read, in the same context "* * * **depend in significant part** * * *" But petitioner's question, even as framed, bears little relation to the record or to the decision of the court below. Only the excess value of the FFA—the possible increases in values above the principal sum underlying the contract (100 per cent of net premiums after 10 years)—are related, and during the deferred period only, to the investment income from or the value of the underlying investments.

2. We refer to the contract in question as the Flexible Fund Annuity (FFA) as did the court below. The FFA is the "Annual Premium Flexible Fund Retirement Annuity" (PX 2; R. II 2-9).

spondent guarantees the formula of an empiric accumulation factor—which can result after maturity in fixed monthly payments for the lifetime of the annuitant in higher amount than that provided by the principal sum. The empiric accumulation factor can also result in a higher death benefit or cash surrender value upon termination of the contract during the deferred period.

The question presented is whether the court below correctly held that the FFA is an "insurance product" under the Court's decision in *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America, et al.*, 359 U. S. 65 (1959), where—in interpreting the exemption provisions of the Securities Act of 1933 for "annuity contracts" and "optional annuity contracts"; and the exemption provision of the Investment Company Act for "any insurance company"; and Section 2(b) of the McCarran Act which leaves the "regulat[ion] of the business of insurance" exclusively to the states—the Court held that to qualify its annuities as "insurance" products within the federal concept, an insurance company must (while underwriting all of the mortality and expense risks associated with the contract) guarantee that at least "some fraction" of the benefits will be payable in fixed dollar amounts, and that there must be "some investment risk-taking" on the part of the insurance company.

STATUTES INVOLVED.

The provisions of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U. S. C. 77a, *et seq.*, and of the Investment Company Act of 1940, 54 Stat. 789, 15 U. S. C. 80a-1, *et seq.*, which are relied upon by petitioner, are set forth in an Appendix to petitioner's Brief (pp. 39-41). Section 2(b) of the McCarran-Ferguson Insurance Regulation Act, 59 Stat. 34, 15 U. S. C. 1012(b) provides:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

STATEMENT.

I. Introductory.

Petitioner filed a complaint (R. I 5-22) in the district court on October 1, 1962, claiming that the contract in question (FFA), a deferred annuity contract issued by the respondent, constitutes 2 unregistered "securities" within the definition in the Securities Act of 1933 (1933 Act), and that the respondent's investments underlying the FFA contracts comprise an unregistered "investment company" within the meaning of the Investment Company Act of 1940 (1940 Act).[3]

Respondent was incorporated in 1926 as an insurance company under the laws of the State of Nebraska—a legal reserve stock, life insurance company[4] (R. I 105). Respondent is subject in all of its operations to the supervision of the Director of Insurance of the State of Nebraska (R. I 105) and of the insurance commissioner (or similar official) of the District of Columbia and of the other 48 States in which it is authorized to do business (R. II 54),

3. Petitioner's complaint asserts, in pertinent part (R. I 5):

> 1. This is an action * * * to enjoin the * * * sale * * * of two types of securities neither of which is registered under the Securities Act of 1933, as amended: (a) certain participations in a fund of securities * * * which are being issued by the Flexible Fund A account and distributed by the defendant * * * and (b) guarantees of the securities issued by the Flexible Fund A account and distributed by distributed by the defendant. In addition, the Commission's action seeks to enjoin the defendant from distributing or redeeming any security issued by the Flexible Fund A account, or making any portfolio investments on its behalf, until that Fund is registered as an investment company * * *.

4. As of December 31, 1963, respondent's assets exceeded $458.4 million (R. II 38); its capital and surplus exceeded $60.2 million (R. II 39); and the face amount benefits of its contracts in force exceeded $3.2 billion (R. II 48).

and to examination by the various states through the National Association of Insurance Commissioners.

The district court dismissed the complaint, ruling (R. I 107) that the FFA is an "insurance product" within the Court's decision in *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America*, 359 U. S. 65 (*VALIC*). Petitioner appealed from the dismissal to the court below, which on March 10, 1966 in an opinion by Chief Judge Bazelon, affirmed the judgment of the district court (R. I 109-115). On October 24, 1966 the Court granted the petition for certiorari (R. I 119). On January 17, 1967 the Court granted a motion of the National Association of Securities Dealers Inc. and of the Investment Company Institute for leave to file a joint brief as *amici curiae* in support of petitioner.

II. The Proceedings in the Courts Below.

Respondent moved [5] in the district court on September 12, 1963 for judgment under Federal Rule of Civil Proce-

5. The respondent supported its motion for summary judgment in part with the following documents:

(i) Affidavit of Dale R. Gustafson, respondent's Actuary. The Brief of the *amici*, p. 15 *et seq.*, relies upon this affidavit.

(ii) Affidavit of N. Murray Longworth, then President of respondent, now deceased.

(iii) Respondent's Annual Statement for 1962 (Forms 1 and 1-S) (Documents nos. 5a, 5b, and 5c);

(iv) National Association of Insurance Commissioners Examination Report (1961) of respondent (Document no. 6);

(v) Defendant's Deferred Retirement Annuity [Form 523, Series 120L] (Document no. 8);

(vi) Copy of Resolution of respondent's Board of Directors, December 6, 1961, authorizing, under Nebraska law, the establishment of separate accounts in connection with FFA contracts and authorizing the transfer from general surplus of the respondent to the separate account of an amount not to exceed $175,000. Initial purchases were made in March-April 1962 of bonds ($60,300) and common stocks ($105,-173.81), at a total cost of $166,170.50. (Document no. 10).

dure 56, on the ground that there were no relevant issues of material fact and that respondent was entitled to judgment, as a matter of law, under the Court's *VALIC* ruling. Petitioner opposed the motion, and the district court (McGarraghy, J.) denied it (R. I 2). Trial was commenced on March 15, 1965, in the district court (Curran, J.). Petitioner rested its case on the same day. Petitioner conceded in the district court that while in *VALIC* there was "no floor", in the FFA there was a floor, the guaranteed minimum cash value (R. I 51); that the annuitant "can't wind up with nothing. There is a guarantee * * * [of] a certain minimum which, in turn, is bound to purchase a certain amount of annuity based on the annuity tables" (R. I 52).[6]

After petitioner rested its case, the respondent moved to dismiss the action under Federal Rule of Civil Procedure 41(b) (R. I 103). The district court granted the respondent's motion, finding that in the FFA the respondent "* * * guarantees to the annuitant a fixed dollar equal monthly retirement income after the maturity date is reached, which income cannot be outlived" (R. I 76). The district court held that the FFA "is, therefore, an insurance product within the interpretation of *VALIC*" (R. I 77).

The court of appeals affirmed. It found that in most respects the FFA and the conventional deferred annuity are identical. It found that the only meaningful difference between the two contracts is that the FFA does not guarantee a fixed interest on the accumulation of net premiums during the deferred period, but offers, in lieu of such a

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6. The colloquy between the district court and petitioner's counsel continued (R. I 52):

The Court: That is not *VALIC*, is it?

Mr. North: It is not *VALIC* in the sense that it could drop to zero.

The Court: *VALIC* could.

Mr. North: That's right.

fixed accumulation factor, an empiric accumulation factor which reflects the actual investment rate realized by respondent on the investments underlying the FFA—while at all times, guaranteeing the principal sum underlying the contract, the accumulation of net premiums themselves (R. I 110). The court of appeals pointed out that both the majority and concurring opinions [7] in *VALIC* implicitly held that an insurance company must bear a substantial part of the investment risk associated with the contract, as well as the mortality and expense risks, in order to qualify its products as "insurance" (R. I 112). The court below found that respondent in the FFA assumes: (a) all of the mortality risk; (b) all of the expense risk; and (c) not only a substantial part, but by far the major part, of the investment risk over the duration of the entire policy (R. I 114). The court concluded that "The obligations of United under the FFA, unlike those of the variable annuity, are stated, in large part, in terms of guaranteed dollar amounts; there is a substantial and meaningful 'floor' to the FFA policy. We therefore conclude that the FFA is an 'insurance' contract and as such beyond the scope of federal regulation under the 1933 and 1940 Acts" (R. I 114-115).

III. The FFA Contract.

A. In General.

The FFA is a deferred (or optional)[8] life annuity.

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7. The four members of the Court who dissented in *VALIC* were of the opinion that the variable annuity is an "insurance product", 359 U. S. 93-101. They were of the view that (at 96):

> * * * It is certainly beyond question that the "mortality" aspect of these annuities—that is the assumption by the company of the entire risk of longevity—involves nothing other than classic insurance concepts and procedures * * *.

8. The term "deferred" annuity is synonymous with "optional" annuity. Congress not only exempted "any annuity contract" but specifically any "optional annuity contract" (1933 Act, § 3(a)(8)).

The FFA and the respondent's conventional deferred life annuity contract (PX 7; R. II 27-34) (which petitioner concedes is an insurance product) are based upon identical principles. During the income-payment period the FFA and the conventional deferred annuity are both premised upon an accumulation factor equal to a guaranteed 2½ per cent interest per annum. In both the respondent assumes all of the mortality and expense risks over the entire duration of the contracts. In both the respondent provides for a fixed death benefit equal to all of the premiums paid. In both respondent provides for a cash surrender value during the deferred period.

The only meaningful difference between the FFA and the conventional deferred annuity lies in the precise nature of the accumulation factor utilized in the FFA during the deferred period. In lieu of a guaranteed interest factor (fixed but limited) as in the conventional annuity, the FFA uses an accumulation factor which is related to the actual net investment rate realized by the respondent on its investments underlying the FFA. Thus, the FFA can be regarded, as the court below found, as an "extension or development or the concept of participating insurance" (R. I 115, note 11).

The FFA guarantees a fixed dollar monthly income after maturity. The payments will be higher if the accumulated cash value—based on the empiric accumulation rate—is higher than the fixed (guaranteed minimum) cash value at maturity.

We analyze first the fixed values—then the possible excess values of the FFA.

B. The FFA Provides for a Fixed (Guaranteed) Monthly Income Measured by the Life of the Annuitant.

The respondent agrees to pay to the annuitant, beginning on the maturity date, a fixed dollar payment each month for the duration of his life, in such amount as the cash value of the FFA contract will then provide under the contract table (PX 2; R. II 5)—"Table of Annuity Options". This is a table, actuarially computed, of monthly payments under certain options [9] for each $1,000 of cash value on the maturity date; it is identical with the table used by the respondent in its conventional deferred annuity.[10]

The minimum monthly amounts payable after maturity is reached are based upon the fixed (guaranteed minimum) cash value. The fixed cash value (PX 2, § 9; R. II 3) is determined by applying an appropriate percentage to the sum of the net premiums. After 10 years the fixed cash value of the FFA equals 100 per cent of the net

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9. The FFA contains (PX 2; R. I 5) 3 optional plans of income payment, one of which must be elected by the annuitant. Option A provides for:

> *Life Annuity, 120 months guaranteed*—Equal monthly payments shall be made for a minimum guaranteed period of 120 months and for as long thereafter as the Annuitant lives. If the Annuitant dies before annuity payments have been made for the said minimum period, annuity payments will be continued for the remainder of said minimum period to the beneficiary.

We assume in all examples used herein that the annuitant has elected Option A.

10. The form of the conventional deferred annuity which the respondent was issuing at the time of the respondent's motion for summary judgment, Form 523, Series 120L. (A specimen of this policy appears as Document no. 8 of the documents submitted with the moving papers in support of the respondent's motion for summary judgment. See note 5 above.) A newer series (PX 7; R. II 27-34) was issued thereafter, containing liberalized interest assumptions and modernized mortality assumptions.

premiums;[11] prior to the 10th year the fixed cash value of the FFA equals an increasing percentage[12] of the net premiums.

In the example[13] of a male, age 35, paying a monthly premium of $100, with Option A elected as the plan of payment and with a maturity date at age 55—the annuitant will receive minimum monthly payments of $109.09, computable from the contract, for as long as he lives. With a maturity date at age 60, the annuitant will receive min-

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11. Net premiums are defined in the FFA as the following percentages of the premiums paid for respective policy years (PX 2; § 7; R. II 3):

Policy Year	*Percentage of Premiums Paid*
1	50.0
2-10	90.5
11 and subsequent	95.0

The expense loadings thus built into the premiums for the FFA, amount to: 50.0 per cent in the 1st year; 9.5 per cent in policy years 2-10; and 5.0 per cent in the 11th policy year and thereafter. These are *identical* with the premium loadings in the respondent's conventional deferred annuity.

12. Prior to the 10th year the fixed cash value of the FFA is equal to an increasing percentage of the net premiums, as follows (PX 2; § 9; R. II 3):

Premiums Paid for Policy Years	*Percentage of Net Premiums*
1	50
2	55
3	60
4	65
5	70
6	75
7	80
8	85
9	90
10 or more	100

13. In the examples given herein it will be assumed throughout that the FFA has been issued to such a male, age 35, with Option A selected, and with a monthly premium of $100. We must assume (although it is not stated) that petitioner uses the same assumptions in its example (Brief, pp. 24-25).

imum monthly payments of $154.13 measured by the duration of his life. The following table shows for policy years 10[14] to 25,[15] the minimum monthly payments which the FFA will provide:

End of Policy Year	*Fixed (Minimum) Monthly Income*
10	$ 42.43
11	48.01
12	54.78
13	59.73
14	66.01
15	72.33
16	79.18
17	86.08
18	93.38
19	101.11
20	109.09
21	117.32
22	125.80
23	134.79
24	144.31
25	154.13

The foregoing amounts are minimums; no consideration has been given to the possibility of additional amounts of monthly income based on the accumulated cash value.

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14. The respondent will not issue an FFA with a maturity date less than 10 years from date of issue. Affidavit of D. R. Gustafson, p. 29 (note 5 above).

15. As of September, 1963, 148 FFA policies had been issued by the respondent providing for maturity dates (on the average) of 24.01 years from their respective dates of issue. *Ibid.*

C. The FFA Provides a Fixed (Guaranteed Minimum) Death Benefit During the Deferred Period.

The FFA provides for a fixed [16] death benefit under which the annuitant's beneficiary will receive an amount equal to 100 per cent of the premiums which have been paid (PX 2; R. II 2), as follows:

Death Occurring at End of Year	*Premiums Paid*	*FFA Fixed (Guaranteed Minimum) Death Benefit*
10	$12,000.00	$12,000.00
15	18,000.00	18,000.00
20	24,000.00	24,000.00
25	30,000.00	30,000.00

The FFA, as does the conventional [17] deferred annuity, gives to the annuitant (or to his beneficiary) the right to elect to have the death benefit paid under any one of 4 specified options.[18] These options require payments after death of the annuitant to the beneficiary at a guaranteed rate of 2½ per cent per annum on the sum of premiums paid or the accumulated cash value, whichever is higher.

16. If the accumulated cash value is higher than the sum of the premiums paid, the annuitant's beneficiary will receive the sum of the premiums paid **plus** the difference between such sum and the accumulated cash value.

17. Compare PX 7; R. II 33.

18. The options (PX 2; R. II 6) are:

Option 1:—Proceeds on Deposit at Interest

Option 2:—Income of a Specified Amount

Option 3:—Income for a Specified Period

Option 4:—Income for a Guaranteed Minimum Period and Life Thereafter

D. The FFA Provides for a Fixed (Guaranteed Minimum) Cash Surrender Value.

All states today have "nonforfeiture laws" which define the minimum amount which must be returned upon surrender of a life insurance policy.[19] Today also most companies issuing deferred annuities provide voluntarily by contract for cash surrender values—by analogy to the requirement for life insurance policies. The respondent's conventional deferred annuity contains such a provision (PX 7, § 18; R. II 31), as does the FFA (PX 2, § 9; R. II 3). The FFA provides for a fixed (guaranteed minimum) cash value and provides that "[a]t any time prior to commencement of Annuity Income, this policy may be surrendered and the Company shall pay the cash value to the Annuitant. The cash value shall be * * * not less than the following minimum amount * * *." In the case of an FFA with a monthly premium of $100 the fixed cash value for policy years 10 to 25 will be as follows, computable from the contract:

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19. Huebner and Black, Life Insurance (6th ed. 1964) p. 374, states:

> Although the practice of allowing a surrender value in some form is an old one, for many years the matter was entirely optional with the companies, with some companies voluntarily granting cash surrender values and others not granting them. All states today have so-called 'nonforfeiture laws' which define the minimum amount that must be returned upon surrender of a policy. Today, most companies provide surrender values in excess of the minimums required by law.

End of Policy Year	*Total Premiums Paid*	*FFA Fixed (Guaranteed Minimum) Cash Value*
10	$12,000.00	$10,374.00
11	13,200.00	11,514.00
12	14,400.00	12,654.00
13	15,600.00	13,794.00
14	16,800.00	14,934.00
15	18,000.00	16,074.00
16	19,200.00	17,214.00
17	20,400.00	18,354.00
18	21,600.00	19,494.00
19	22,800.00	20,634.00
20	24,000.00	21,774.00
21	25,200.00	22,914.00
22	26,400.00	24,054.00
23	27,600.00	25,194.00
24	28,800.00	26,334.00
25	30,000.00	27,474.00

E. Possible Excess Benefits Depending on the Accumulated Cash Value.

The fixed (minimum) benefits provided for by the FFA include: (a) monthly payments for life after maturity in guaranteed fixed dollars; (b) a death benefit before maturity equal to 100 per cent of the premiums paid; and (c) a cash surrender value equal (after the 10th policy year) to 100 per cent of net premiums. In addition to these fixed (minimum) benefits the FFA provides for possible *excess* benefits which depend upon the accumulated cash value.

If at maturity the accumulated cash value exceeds the fixed (minimum) cash value, the annuitant will receive the monthly payment provided for by the fixed cash value, in-

creased by any additional amounts provided for by the excess of the accumulated cash value over the fixed cash value. Amounts of accumulated cash value in excess of the fixed minimum cash value automatically will result in the payment after maturity of a higher level of monthly income than will be provided by the fixed cash value alone.

During the deferred period, the cash value of the FFA equals the fixed (minimum) cash value *plus* the excess of the accumulated cash value over the fixed cash value.[20] The accumulated cash value of the FFA is the accumulated value as of the end of the previous month multiplied by the monthly accumulation rate as determined by the respondent for such month on the basis of the relevant provisions of the contract (PX 2, § 8; R. II 3). At any time the accumulated cash value is the sum of the accumulation [21] of the successive net premiums paid. The monthly accumulation rate is an arithmetic formula (R. I 80-81), which shows: (a) the income received from the investments underlying the FFA, and (b) the change in the values of those investments, reduced by the allowance for the "actuarial margin" and a reserve for possible federal income (capital gains) tax of respondent. The monthly accumulation rate reflects the actual monthly experience of the respondent in connection with the investments which underlie the FFA, that is, respondent's investments which have been acquired with respondent's funds allocated to a separate account authorized by Nebraska law. This statute provides, in part, that "[a]mounts allocated by a life insurance company to sepa-

20. The FFA provides (PX 2, § 9; R. II 3):

* * * The cash value shall be the amount of accumulated value as of the last day of the previous month * * * but not less than the following minimum amount [the fixed value] * * *.

21. By "accumulations" is meant each net premium multiplied by each of the monthly accumulation rates subsequent thereto.

rate accounts * * * shall be owned by the company, and the company shall not be, or hold itself to be, a trustee in respect to such amounts."[22] In insurance terminology a separate acount is an "operational manner of proceeding" whereby an insurance company is enabled to perform its legally incurred obligations to a certain group of policyholders.[23]

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22. Revised Statutes of Nebraska, 1963 Cumulative Supplement [R. S. Supp., 1963] § 44-310.06. The FFA states (PX 2, § 6; R. II 3) that it is issued under the authority of a Nebraska statute which provides for separate accounting of the experience of a selected group of investments acquired with amounts allocated to a separate account known as Flexible Fund A account. Under Nebraska law life insurance companies are required to keep their participating and non-participating business in separate accounts, and to maintain complete separation between the accounts. Nebraska Reissue Revised Statutes of 1943 [R. R. S. 1943], § 44-708. R. S. Supp. 1963, § 44-310.06 provides:

> Any domestic life insurance company may, after adoption of resolution by its board of directors and certification thereof to the Director of Insurance, allocate to one or more separate accounts, pursuant to the provisions of applicable contracts, any amounts which are paid to such company in connection with a pension, retirement, or profit-sharing plan or annuity, and which are to be applied to purchase annuities or retirement benefits under such company's policies or contracts and to provide other benefits incidental thereto. The income, if any, and gains or losses, realized or unrealized, on each such account may be credited to or charged against the amount allocated to such account in accordance with such contract, without regard to the other income, gains, or losses of the company. The amounts allocated in such accounts and accumulations thereon may be invested and reinvested in any class of loans and investments authorized for domestic life insurance companies and such loans and investments shall not be included in applying the limitations provided in section 44-310.02. Amounts allocated by a life insurance company to separate accounts in the exercise of the power granted by sections 44-310.06 to 44-310.08 shall be owned by the company, and the company shall not be, or hold itself to be, a trustee in respect to such amounts.

23. A Symposium on Segregated Accounts, Proceedings of the Fifty-Fourth Annual Meeting of the Legal Section of the American Life Convention, p. 264 (1961). Some 35 states in 1963

The respondent's conventional deferred annuity during both the income-payment period and the deferred period, and the FFA during the income-payment period, is based upon an accumulation factor equal to a guaranteed 2½ per cent interest per annum. The accumulation factor (fixed interest), though guaranteed, is set comparatively low.[24]

If the accumulated cash value of the FFA is in excess of the fixed (minimum) cash value on the maturity date, the monthly lifetime payments will be higher. Further, if the annuitant dies and the contract terminates involuntarily —and the accumulated cash value exceeds the sum of the premiums paid—the annuitant's beneficiary will receive the higher amount (and will have the right to elect one of the 4 optional plans of settlement with respect to such higher amount). In the event that the annuitant voluntarily terminates his contract and elects to receive the surrender value thereof, and the accumulated cash value exceeds the fixed (minimum) value, he will receive the higher amount.

It may be expected that the retirement payments will commence on the maturity date selected. In the event of

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had legislation authorizing the use by life insurance companies of separate accounts in connection with individual or group contracts. D. S. MacNaughton, Separate Accounts—Investment Year, American Life Convention, Legal Section Proceedings, 1963, p. 33.

24. As the court below pointed out (R. I 114) in the case of a participating annuity the interest factor during the deferred period is deliberately set quite low so as to assure dividends. The FFA extends this principle, guaranteeing no interest, but guaranteeing a formula to reflect actual investment results—in return for the FFA contractholder's opportunity to realize the benefit, after maturity, of favorable investments achieved over the entire duration of the deferred period. In *actuarial* terms the FFA does guarantee a *fixed* interest factor during the deferred period—0 interest. This is a significant interest guarantee which protects the annuitant against the erosion of the principal sum, which could be caused by a net investment rate over the entire deferred period of a *negative* interest factor.

involuntary termination of the contract by death or of voluntary termination by election of the annuitant, the excess values generated by the accumulated cash value will be available, in addition to the fixed value, as a terminal dividend.

F. The FFA's Expense Allowances.

There are only two allowances built into the FFA contract to cover all of the respondent's expenses associated with the contracts: (a) the premium "loadings" (identical to those fixed in respondent's conventional deferred annuity); and (b) the "actuarial margin"—a monthly allowance of .083 per cent [25] of the value of the assets underlying the FFA. If the expenses connected with the FFA over the life of all the contracts (an FFA taken out for an infant might last 75 years or more) are not covered by these two contractual expense allowances—then the excess portion will have to be paid out of the respondent's surplus. If the experience of the respondent's investments underlying the FFA over the years of the deferred periods is favorable the actuarial margin will result in a larger dollar sum being available for expenses than would be otherwise. Thus the respondent's success in its investment policy applied to those investments will affect the respondent in a very significant way.

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25. The formula for the monthly accumulation rate makes provision, in effect, for an allowance of .083 per cent of the value of the underlying investments since it utilizes 99.917 per cent as a factor. The actuarial margin amounts per annum to .996 per cent of the value of the assets in the separate account.

IV. The FFA Contract Business, as an Integral Part of the Respondent's Operations, Is Subject to the Supervision of the Nebraska Director of Insurance and to Examination Through the National Association of Insurance Commissioners.

Petitioner makes but little reference to the documents which it put into the record in the district court, including the Annual Statement of the respondent (for 1963) which must [26] be filed each year under Nebraska law.

The respondent is subject in all aspects of its business (including FFA contracts) to the direct and plenary supervision of the Nebraska Director of Insurance (R. I 105). This is also exemplified in the respondent's Annual Statement for 1963: Form 1 (PX 8-A; R. II 35-66) and Form 1-S (PX 8-B; R. II 67-92), which forms are part of the record printed for use of the court below.[27] The Annual Statement for 1963 was, of course, prepared on the forms ("blanks") approved by the National Association of Insurance Commissioners. For 1963, Form 1-S had been devised by the Blanks Committee for the reporting of all transactions relating to any separate account business. The FFA contractholder has contractual claims against the respondent and all of the assets of the respondent are available to meet those claims; therefore, reference is necessary to both Form 1—as well as Form 1-S—to obtain a correct and complete picture of the FFA line of business.

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26. R. R. S. 1943, § 44-322. Also at least every 3 years the affairs of every insurance company operating in Nebraska must be examined in a so-called Association Examination. R. R. S. 1943, §44-107. (Such report for 1961 was submitted as Document no. 6 in support of the respondents' motion for summary judgment. See note 5 above.)

27. The Annual Statement for 1963 also includes Investment Schedules (PX 8-C) which were not included in the record prepared for use of the court below.

Form 1 includes in its totals for assets and liabilities of the respondent those amounts which are shown for reporting and regulatory purposes separately on Form 1-S. Form 1 shows [28] total assets of the respondent for the year ended December 31, 1963 of $458,467,439.38, and shows [29] separately of that total $286,290.33, as Separate Account Business and refers to Form 1-S. Form 1 shows [30] total liabilities of $398,263,025.66, and shows separately [31] of this total $114,281.78 as Separate Account Business. Form 1 shows [32] unassigned surplus of $54,204,413.73, which includes an amount of surplus in the separate account.

On each of the blanks of Form 1 there is a specific indication as to whether the page in question includes or does not include separate account items.[33]

Form 1-S (PX 8-B; R. II 67-93) was devised to present for reporting and regulatory purposes all possible information for all transactions related to any separate account. Form 1-S shows total assets of $286,290.33 (as was indicated on Form 1) comprised of bonds of a market value of $87,194.15, stocks of $196,465.42, separate account clearing of $46.36, and investment income accrued of $2,584.40.[34] Form 1-S shows liabilities of $114,281.78 (as was indicated on Form 1) of which $110,159.69 represents "[a]ggregate reserve for life policies and contracts"; $229.76 represents general expenses accrued and $3,892.33 represents federal

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28. PX 8-A, p. 2, line 26: R. II 38.

29. *Id.* line 25A.

30. *Id.* p. 3, line 26; R. II 39.

31. *Id.* line 25A.

32. *Id.* line 29.

33. Separate account items appear also on pages 4, 17, 34 and 45 of Form 1 (PX 8-A; R. II 40, 54, 58, 66).

34. PX 8-B, p. 2, lines 1, 2, 9, 19 and 26; R. II 70.

income taxes accrued on capital gains,[35] unassigned surplus is shown as $172,008.55.[36]

V. Respondent's Reserves for FFA Contracts.

As a legal reserve life insurance company the respondent operates under laws which specify the minimum basis for reserves maintained in connection with its contracts. The reserves maintained in connection with FFA contracts fall into two categories—policy reserves and other (non-policy) reserves. Policy reserves held for FFA contracts consist of (a) the aggregate accumulated cash values[37] of FFA contracts and (b) a contingency reserve[38] to cover the fixed (minimum) death benefit during the deferred period. The foregoing is in accord with the FFA contract which provides that during the deferred period the aggregate reserves for FFA contracts "shall be the sum of the cash values, increased by such contingency reserve as may be necessary to cover the minimum death benefit guarantee." (PX 2, § 13; R. II 4) and that during the income-payment period "the reserve shall be based on the 1937 Standard Annuity Table of Mortality rated down one year for males and six years for females, with interest at two and one-half per cent" (*ibid.*).

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35. *Id.* p. 3, lines 4, 15A, 26, 24, 30 and 31; R. II 71.

36. *Id.* line 29. This figure represents the amount remaining after the accumulated cash values of all FFA contracts have been computed. The respondent originally allocated $166,170. of general surplus to the separate account. The FFA contractholders have no "pro rata share" of the investments allocated to the separate account. The accumulated cash values of the contracts depends upon the monthly accumulation rates and the formula treats the original amount of $166,170. of surplus quite differently than the amounts of accumulated cash values of FFA contracts. No pro rata share computation is possible.

37. This appears as $110, 159.69 on Form 1-S, PX 8-B, p. 2, line 1; R. II 71.

38. Reflected in the figure shown on line 1, p. 3 of Form 1 (PX 8-A; R. II 39).

VI. State Regulation of the Respondent's Investments.

Nebraska law regulates the investments which are legal for life insurance companies and these provisions of Nebraska law apply to respondent's investments underlying the FFA.[39] Nebraska law authorizes the use of separate accounts, under which there is no limitation on the percentage of common and preferred stocks which may be acquired.[40] The separate account mechanism thus allows "flexible funding" of the respondent's contract obligations.

39. R. S. Supp. 1963, § 44-309(9)-(10) set up specific qualitative criteria as to preferred and common stocks which may be acquired by the respondent.

40. R. S. Supp. 1963, § 44-310.06; see note 22 above.

SUMMARY OF ARGUMENT.

A. The FFA contract is an "insurance product" within the Court's *VALIC* decision. The contract contains a guarantee that at least some portion of the benefits will be payable in fixed amounts and the respondent undertakes some investment risk. Having complied with this minimal federal standard, the FFA is exempt from federal regulation, and is subject exclusively to the control of the Director of Insurance of the State of Nebraska and of the commissioners of the other states. The respondent, also, in its business of issuing FFA contracts is subject exclusively to the control of the Nebraska Director of Insurance and to examination by the insurance commissioners of all states in which the FFA has been approved.

B. Within the more onerous test utilized by the court below, the FFA also is an "insurance" product. The respondent undertakes all of the mortality and expense risks over the entire duration of the contract. As to investment risk, the respondent guarantees the principal sum underlying the contract during the deferred as well as the income-payment period; the respondent guarantees an annual yield on the principal during the income-payment period of a fixed 2½ per cent, and guarantees the benefit after maturity, of practically all of the income and gains actually achieved on the underlying investments during the deferred period. In addition, the respondent guarantees a substantial fixed (minimum) cash surrender value for the FFA during the deferred period, an amount equal to all of the net premiums after the 10th year, and a substantial fixed (minimum) death benefit to the annuitant's beneficiary during the deferred period, an amount equal to all of the premiums. In both instances the amounts may be higher

by virtue of a terminal dividend reflecting the income and gains achieved on the underlying investments over the deferred period.

C. The FFA is a deferred (or optional) life annuity; it promises a guaranteed fixed (minimum) monthly lifetime income after the maturity date is reached. As such an annuity it falls directly within the provision of the 1933 Act excluding from its coverage "any annuity contract" or "any optional annuity contract." The respondent generally, and in its issuing of FFA contracts, falls within the provision of the 1940 Act excluding from its coverage "any insurance company." Both respondent and the FFA contract fall within the protective ambit of the McCarran Act which leaves the regulation of the business of insurance solely with the states. No intention can be imputed to congress that these exclusions should be removed in the event of an evolution in the annuity concept. Congress intended in enacting the 1933 Act, to exempt optional annuity contracts in any evolved form they might take. Congress exempted optional annuities issued on a participating basis, and no intention can be imputed to Congress that the exemptions should be removed because an insurance company issues an evolved form of participating annuity.

D. Petitioner's contentions are based upon a fragmentizing of the contract. Petitioner seeking regulation of only a portion of the FFA (and presumably of only those operations of respondent which relate thereto). Petitioner engages in the fiction of considering the sums which respondent must maintain for FFA contracts as assets which belong—not to the respondent—but solely to the contract holders. Petitioner ignores the basic relationship between the annuitant and the respondent which is that of creditor and debtor. The FFA holder has contract claims

against the respondent; all of the respondent's assets are available to meet those claims; the annuitant does not own any portion of the respondent's assets.

E. Petitioner seeks to impose all of the elaborate controls embodied in the 1933 and 1940 Acts upon respondent, because of the presence in the FFA of an evolved participation feature. This participation feature is subject to direct and meaningful regulation by the state commissioner. Federal controls are irrelevant; they would lead to the absurd result that the contractholders—not the respondent—would have the control of the respondent's investments underlying the FFA contracts. The FFA owner is not an investor; he is an annuitant. It is the respondent which is an investor; respondent is subject to the fluctuations of the securities markets. The respondent has underwritten all the investment risk which the annuitant would otherwise have during the income-payment period; it has underwritten the annuitant's risk of "losing" the principal sum underlying the FFA contract during the deferred period. Further, the very essence of the FFA is that the respondent has—in a practical sense—and identically with the issuer of a participating annuity, underwritten the risk of producing an investment rate during the deferred period which will make the product salable and competitive. The annuitant expects that the respondent will have the burden and responsibility for carrying on the investment function to produce a satisfactory yield—knowing that at all times his retirement income is safe.

ARGUMENT.

I. The FFA Is an "Insurance Product" Within the Meaning of the Court's *VALIC* Decision.

A. Under the Court's *VALIC* decision an insurance product exempt from the federal securities laws is one which involves "some" guarantee of fixed income, that is, a guarantee that at least "some" fraction of the benefits will be payable in fixed amounts.

1. THE COURT'S *VALIC* RULING.

In *VALIC* the Court said that the issuer of a variable annuity assumes the risk of mortality from the moment the contract is issued. It was this feature which the variable annuity companies stressed when they urged the Court to find that the variable annuity was an "insurance product", 357 U. S. at 70. But the Court held (*Id.* at 71-72):

> The difficulty is that, **absent some guarantee of fixed income**, the variable annuity places **all** the investment risks on the annuitant, **none** on the company. The holder gets only a *pro rata* share of what the portfolio of equity interests reflects—which may be a lot, a little, or nothing. * * *.

The Court pointed out also (*id.* at 71-73):

> * * * We deal with a more conventional concept of risk-bearing when we speak of "insurance". For in common understanding "insurance" involves a guarantee that at least **some fraction** of the **benefits** will be payable in **fixed** amounts. See Spellacy v. American

Life Ins. Ass'n, 144 Conn. 346, 354-355, 131 A. 2d 834, 839; Couch, Cyclopedia of Insurance Law, Vol. 1, § 25; Richards, Law of Insurance, Vol. 1, § 27; Appleman, Insurance Law and Practice, Vol. 1, § 81. The companies that issue these annuities take the risk of failure. But they guarantee **nothing** to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling **but no floor. There is no true underwriting of risks**, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.

The majority of the Court in *VALIC* were of the view that if an insurance company develops an annuity contract in which the company makes "some" guarantee of fixed income after maturity, i.e., it guarantees that "some" fraction of the benefits will be payable in fixed amounts; such an annuity contract is an "insurance product" exempt from the federal securities laws.

Mr. Justice Harlan (dissenting), speaking also for Justices Frankfurter, Clark and Whittaker, was of the opinion (359 U. S. at 96) that "the 'mortality' aspect of these [variable] annuities—that is, the assumption by the company of the entire risk of longevity—involves nothing other than classic insurance concepts and procedures". Further, Mr. Justice Harlan could find "nothing in the history of the Securities Act of 1933 which savors in the slightest degree of a purpose to depart from or dilute this traditional federal 'hands off' policy respecting insurance regulation" (*id.* at 97). He found in the variable annuity "an experiment designed to accommodate annuity insurance coverage to contingencies of the present day economic climate" (*id.* at 100), and he pointed out that the Court had "agreed that we should not 'freeze' the concept of insurance" as it

existed in 1933 and 1940 (*id.* at 101). By the same token, said Mr. Justice Harlan, "we should not proceed on the assumption that the thrust of state regulation is frozen. As the insurance business develops new concepts, the States adjust and develop their controls. This is in the tradition of state regulation and federal absention" (*ibid.*).

Mr. Justice Brennan (concurring), speaking also for Mr. Justice Stewart, described in detail his view that the factor of investment risk was determinative. He pointed out that the purpose of the federal regulatory scheme had only minimal relevance to conventional insurance and annuity policies, which assumed the investment risk by creating fixed monetary obligations, and that state regulation of reserves and solvency offered meaningful protection to the policyholder. He reasoned that since the variable annuity did *not* include substantial fixed dollar guarantees federal regulation was *relevant* while state regulation was not. Mr. Justice Brennan, therefore, held the variable annuity contract to be a "security" subject to the 1933 and 1940 Acts.

All members of the Court warned against the freezing or petrifying of the concept of the annuity into a single pattern, and urged that development and growth of insurance concepts should be allowed. The majority and concurring Justices were of the view that to escape the imposition of the dual federal controls embodied in the securities laws upon state controls, an insurance company must meet a minimal test—it must bear "some" part of the investment risk associated with the contract. The issuer of the variable annuity—like the investment company—assumes no part of that investment risk; that risk remains *in toto* upon the annuitant. It was petitioner which urged the Court in *VALIC* to establish this minimal test for federal purposes.

In *VALIC* petitioner urged [41] with regard to the variable annuity companies:

> At no time under any of the contracts issued by the respondents is **any portion of the purchaser's risk of investment loss** borne by the respondents (Finding of Fact 49, R. 108). Respondents assume **only** the risk that the purchaser will survive his estimated mortality, in which event he will be entitled to be supplied with the value of additional annuity units.

And further petitioner urged [42] in *VALIC* in the court below:

> In assuming the risk of loss, the true insurance policy provides for at least **a minimum payment of a fixed sum.**

The reason for the petitioner's urging in *VALIC* of a test in minimal terms for federal purposes, we submit, resulted from petitioner's recognition that annuities are subject to comprehensive state regulation, and also that an insurance company's products are subject to intense competition in the market place from the products of other insurance companies. The Court, apparently, in *VALIC*, was aware that state regulation, as well as the factor of the salability [43] of annuity contracts, are factors with essen-

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41. Brief for Petitioner, p. 8. It will be noted that "investment risk" refers to the "**purchaser's risk** of investment loss". The court below correctly pointed out that petitioner now misconceives the concept (R. I 113).

42. Brief for the Securities and Exchange Commission, Appellant (United States Court of Appeals for the District of Columbia Circuit) p. 33.

43. Compare 359 U. S. at 90 where Mr. Justice Brennan commented on a hypothetical form of a "participating" annuity where the fixed guarantee of the traditional life annuity would be reduced "to the point of **insignificance**," and the rest of the return to the contract holder would be "variable." He said the "comparison of the premium cost of such a contract to its fixed return might well make it unsalable to the public."

tially control the level of benefits in annuity policies and the fairness of their provisions, matters exclusively for the states after federal minimal requirements have been met. The moment an insurance company promises some guaranteed dollar amounts of income, or some fraction of benefits in guaranteed dollar amounts, the company assumes an insurance risk in the federal sense. *Helvering v. Le Gierse,* 312 U. S. 531 (1941).

2. Petitioner Concedes That *VALIC* Established a Minimal Test, and That the Respondent Has Met That Test of "Some" Investment Risk-Taking.

Petitioner concedes (Brief, p. 15)[44] that the *VALIC* test involves "some" investment risk taking on the part of the company. Petitioner also asserts (Brief, p. 12) that by guaranteeing the principal sum during the deferred period (lifetime income available therefrom after maturity date is also guaranteed), the respondent:

> * * * undoubtedly assumes some risk * * *

Petitioner thus concedes, we submit, that the respondent meets the *VALIC* test.

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44. Petitioner took the same view on certiorari, Reply Brief for the Securities and Exchange Commission, p. 2:

> * * * The decision in *VALIC* rested on the narrow ground that since "the concept of 'insurance' involves some investment risk-taking on the part of the company," an arrangement which "places all the investment risks on the annuitant, none on the company" (359 U. S. at 71) was not insurance. * * *

3. The Court Below Found That the Respondent Assumes "Some" Investment Risk.

The court below found that the respondent had assumed the "major part" of the investment risk associated with the FFA over the duration of the contract (R. II. 114). We do not believe the court below had to go that far. The court further held (R. I 114-15):

> • • • The obligations of United under the FFA, unlike those of the variable annuity, are stated **in large part,** in terms of **guaranteed** dollar amounts; there is a substantial and meaningful **"floor"** to the FFA policy. • • •

The amount of the fixed (guaranteed) minimum cash value is stated in terms of *guaranteed* dollar amounts. The amount of the fixed (minimum) death benefit (the sum of the premiums paid) is stated in terms of *guaranteed* dollar amounts. The fixed (minimum) amount of monthly income for the life of the annuitant is stated in terms of *guaranteed* dollar amounts. The court below correctly found, in substance, that respondent assumes in the FFA *some* investment risk taking. Therefore, the FFA is an "insurance" product within the meaning of the Court's *VALIC* decision.

B. Under the more onerous test utilized by the court of appeals the FFA is an insurance product. The respondent bears a "substantial part" of the investment risk associated with the contract.

1. The Decision of the Court of Appeals.

The language of the Court in *VALIC* means, we submit, that for an insurance company to qualify its products as "insurance" in the federal sense, the company must bear

some portion of the investment risk associated with the contract. The court of appeals, however, read *VALIC* as requiring an insurance company to bear more than some portion of the investment risk associated with an annuity contract; it must bear a substantial risk:

> * * * In sum, both the majority and concurring opinions implicitly held that a company must bear a **substantial part** of the **investment risk** associated with the contract, as well as the mortality and expense risks, in order to qualify its products as "insurance". (R. I 112)

Under this more onerous standard derived from *VALIC* the FFA, also, as the court below correctly held, is an insurance product.

2. The Respondent Bears a Substantial Investment Risk in the FFA.

(a) *Petitioner concedes that the respondent bears substantial risks.*

Petitioner does not dispute that the respondent bears substantial mortality and expense risks in the FFA. As shown above, petitioner concedes also that the respondent bears some investment risk in the FFA. Further as we read its Brief (p. 13) petitioner does not seriously dispute that the investment risk undertaken by the respondent in the FFA is substantial. Petitioner therefore seeks to cast the issue in terms other than the substantiality of the investment risk assumed (*Ibid.*).

(b) *"Investment-risk" under VALIC denotes risk upon the annuitant (not upon respondent) of "losing money".*

The term "investment risk" as used in *VALIC* denotes risk on the annuitant (not on the respondent) of losing money. The district court in *VALIC* had found, as noted above, that the risk of profit or loss on investment is borne by the contractholders. It was argued in *VALIC* that the variable annuity companies did not assume any part of such risk.

In the FFA the annuitant transfers to the respondent all of the mortality risk, all of the expense risk, and the major portion of the investment risk over the entire duration of the contract. The court below held that petitioner misconstrued the concept of investment risk used in *VALIC* by focusing only upon the likelihood of the respondent's having to dip into surplus for reserves under the FFA in connection with the fixed (guaranteed minimum) value at termination or maturity. The court below pointed out (R. I 113-114):

> * * * Presumably no insurance company will undertake a guarantee in any policy if there is a substantial possibility that it will have to resort to **surplus** to satisfy that obligation. Instead of denoting the company's risk, we think the concept refers to the **annuitant's** risk of losing money—**principal**, as well as anticipated earnings on principal—over the course of the investment period. By guaranteeing **principal**—100 per cent of net premiums—United has assumed a **substantial part** of this risk during the **deferred** period of the contract. Were the annuitant to invest on his own in the stock market, or even in so-called "safe" securities

like bonds and mortgages, he would never have this guarantee and his principal would never be absolutely secure.

The Court pointed out in *VALIC* that a variable annuity lacks the "one earmark of insurance" which is the "true underwriting of risks", 359 U. S. at 73. In the FFA the respondent underwrites all the risks: (a) it underwrites the mortality risk; (b) it underwrites the expense risk; (c) it underwrites the investment risk, except that the investment risk during the deferred period is underwritten as to the principal sum and as to the terms of the formula for accumulation of net premiums.

The table of the amounts of monthly income which are available after maturity in the FFA is based upon actuarial predictions of life expectancy. The annuitant transfers from himself to the respondent the risk of "living too long."[45] The respondent assumes the risk of preserving capital and producing yield and of liquidating the amounts on an actuarial basis over the lifetime of the annuitant.

As the court below pointed out, the annuitant transfers to the respondent the risk of "losing principal" during the deferred period. This is a true underwriting of risk by any standard. "Were the annuitant to invest on his own in the stock market, or even in so-called 'safe' securities * * *, he would not have this guarantee, and his principal would never be absolutely secure" (R. I 114). The court below was obviously correct in pointing out, that the respondent by guaranteeing 100 per cent of the sum of net premiums has assumed a substantial part of the investment risk, during the deferred period of the contract (R. I

45. In *VALIC* the Court held that the mortality risk assumed by the variable annuity companies was "apparent, not real; superficial, not substantial" (359 U. S. at 71). In the FFA the fixed values make the mortality risk assumed by the respondent "**real * * * and substantial.**"

113). It is a guarantee that is totally absent in the investment company share or the variable annuity contract.

Petitioner errs when it frames the test of underwriting of investment risk in terms of whether the respondent's expense allowances will prove sufficient over the years to support the guaranteed values—that is, whether the respondent itself will lose money on the line of business. Respondent has predicated the FFA upon certain judgments—one such judgment was predicated upon the effect of certain assumed market actions over the years to come. However, the actual investment experience of the respondent may prove to be completely different from the assumptions made. Thus, the respondent bears the risk of adverse investment experience which may be at variance with the respondent's assumptions: petitioner itself has expressed herein the view that the movement of the stock market over a long period of years is an "unpredictable event"[46], and petitioner should therefore be the first so to concede.

Petitioner makes a rather surprising argument—that the respondent assumes no substantial investment risk—based upon some work sheets of respondent concerning the worst declines in one popular stock market average for the period 1933-1960; the analysis, however, omitted the period 1929-1932—historically the *worst* period of decline.[47] It is

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46. Brief for Appellant (United States Court of Appeals for the District of Columbia Circuit), p. 48. This is also the conclusion of E. F. Fama, Random Walks in Stock Market Prices, Financial Analysts Journal, Sept.-Oct., 1965, pp. 55-59. Petitioner's very "Statement of Policy" (PX 15; R. II 93) with regard to advertising sales literature of investment companies warns that representations may be improper which are based upon the contention that past prices of securities are a basis for asserting what their prices will be in the *future* (PX 15, ¶¶ (a)(2), (b)(1), (c), (e), (f), (g)(2) and (j); R. II 94-96).

47. PX 17; R. II 119. Petitioner did not call as witness any of the respondent's personnel who made the studies to explain their nature or purpose or to evaluate their results.

interesting to note that an attempt by others to set up a so-called "guaranteed mutual fund",[48] where the investor's principal would be guaranteed by a casualty company, was abandoned because a similar study of the period 1918-1938 showed such high losses that it would require too high a

48. In D. Thornsjo, the Variable Dollar Frontier Revisited, Best's Life News (July 1966) [cited in the Petition p. 14] it is pointed out (p. 18):

> As far back as June of 1961 at least one American insurance man began efforts to offer a package that would guarantee an investor against loss provided the investor followed dollar cost averaging in a particular mutual fund over a 10-year period. Extensive research was carried out through a casualty company. Of particular note was a study completed by the actuarial firm of Joseph Froggatt & Co. of New York. Froggatt & Co. began their studies of the market in 1929 and carried them through 1961. In this time period the investor whose [*sic*] dollar cost averaged his investments on a monthly basis in the Dow Jones Average, would have obtained a profit in every 10-year period. Armed with these statistics and a rate developed by Froggatt & Co., the casualty company drew a surety bond guaranteeing the principal of such an investor and had same accepted by the Minnesota Insurance Division. The casualty company then proceeded to assemble a guaranteed mutual fund package with a large and nationally known mutual fund organization. Simply stated, it was intended that through the casualty company the purchaser of a 10-year contractual mutual fund program would be offered a policy guaranteeing that at the end of the specified period the purchaser could redeem his contract for the then net asset value of his fund shares, or could claim under the surety bond by assigning said shares, in which event the investor received the cumulative amount of his monthly investments.
>
> Approval of a state insurance department was but one step toward the various administrative filings which are required for a new variable dollar product. The staff of the SEC questioned the validity of the rate and the amount of capital and surplus in the casualty company, taking the position all the while that the integrated nature of the policy and contractual plan required both to be collectively registered as a separate security. Accordingly, late in 1962, the casualty company requested another actuarial study, this time starting in 1918 and extending through 1938. The results of this study contributed in a major way to the subsequent decision to abandon the attempt to offer to guar-

premium. Petitioner is aware of this attempt, and its characterization of the risk taken by the respondent as "unsubstantial" is less than frank.

(c) *The court below correctly held the respondent's assumption of investment risk to be substantial.*

Petitioner erroneously insists that the FFA contract must be fragmented, and the investment risk during the deferred period only should be considered, a concept which the court below rejected. The court below held that petitioner's guarantee of principal and 2½ per cent interest thereon during the income-payment period is a substantial assumption of investment risk, which should not be ignored; the *VALIC* opinions, as well as common sense, indicate that a challenged policy should be viewed as a whole in order to test its amenability to federal regulation. The court below concluded that the respondent has assumed:

> * * * not only a **substantial part**, but by far the **major part**, of the investment risk over the duration of the entire policy * * * (R. I 114).

Respondent guarantees that the fixed (guaranteed minimum) cash value of the FFA during the deferred period shall (after the 10th year) never be less than 100 per cent of the sum of the net premiums—that the annuitant shall never receive less than a monthly income for his life which

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antee dollar cost averaging investments. The 1918 to 1938 study showed losses occurring in four 10-year periods, 1922-1931, 1923-1932, 1924-1933, 1925-1934. In all periods studied, a $100 per month contractual program was utilized with the Dow Jones 30 Stock Index as the assumed investment media. The ending value of a $12,000 total investment in the 1922-1931 period was $8,033.26; the 1923-1932 period was $5,944.68; the 1924-1933 ending value was $10,104.23; the 1925-1934 period was $10,400.90. In view of the very high premium which would have to be charged to cover such losses, it seemed best to abandon the "magic" of a guaranteed mutual fund.

will be provided by that fixed (guaranteed minimum) cash value—and that upon the death of the annuitant during the deferred period his beneficiary will receive a death benefit equal to the sum of the premiums which have been paid. These guaranteed dollar amounts are, in the language of the Court in *VALIC* and as found by the court below, a substantial and meaningful *"floor."*

(d) *The respondent, in a practical sense, has underwritten the investment risk of producing yield during the deferred period.*

The court below held (R. I 114) that the substantiality of the investment risk which the respondent assumes in the FFA is even more apparent when the FFA is compared with a conventional participating policy. In such a policy the interest factor during the deferred period is deliberately set quite low so as to assure dividends. While dividends are in theory discretionary, in practical terms, they must be declared regularly or the company will lose too much business. The court below pointed out that, in effect, a participating policy promises an opportunity to benefit by greater interest when that is earned (R. I 114, note 11). The FFA extends this principle. The FFA guarantees a 0 interest rate in return for an opportunity to benefit even more fully by excess interest when that is earned. It is for this reason, said the court below, that the FFA "can be regarded as an extension or development of the concept of participating insurance (R. I 114-115, note 11).[49] The

49. The FFA differs from the conventional participating annuity (and in favor of the annuitant) not only with respect to the annuitant's opportunity for greater benefit by greater interest when that is earned, but in its automatic feature. The FFA contract stipulates that the accumulated cash value of the FFA will automatically reflect all the favorable investment results—less an annual deduction of 1 per cent for the actuarial margin and less a reserve for the respondent's possible federal income (capital gains) taxes.

respondent not only assumes, in the strict sense, "a substantial part, but by far the major part of the investment risk over the duration of the entire policy" (R. I 114), and not only assumes all of the investment risk during the income-payment period—but, in practical terms assumes a substantial investment risk during the deferred period too. If the respondent does not achieve and, (as contractually stipulated) pass on to the FFA contractholder in the form of a higher level of monthly payments after maturity, an average net investment rate in excess of 2½ percent per annum (the accumulation factor guaranteed in the respondent's conventional deferred annuity) or the rates achieved or guaranteed by the annuities issued by competitive insurance companies—then the FFA contract will certainly not prove to be a successful line of business.

(e) *Petitioner has admitted, in effect, that the respondent has assumed a substantial investment risk over the entire duration of the FFA.*

Throughout this litigation petitioner has remained silent on the subject of the quantum of investment risk which an insurance company must assume in a deferred annuity before petitioner administratively will adopt a "hands off" policy for that company's annuities. Petitioner has, however, indirectly admitted the substantiality of the investment risk assumed by the respondent. Petitioner has conceded that the respondent's conventional deferred annuity (in which the accumulation factor during both periods is a guaranteed interest rate of 2½ percent per annum) is *not* a security. The conventional deferred annuity issued by respondent has a cash value at the end of the 10th policy year of $11,561.08; it will provide from that yearly a monthly income of $47.28 for the life of the annuitant. In the 20th year of the cash value of the con-

ventional annuity would be $26,895.08, and the monthly income $134.74.

Petitioner thus concedes that in making these promises in the conventional annuity of guaranteed cash value and lifetime income, the respondent assumes a substantial investment risk.

Can petitioner rationally dispute the fact that the FFA—which in the 10th year has a cash value of $10,374.00 and which will produce a monthly income of $42.43 for life, and which has a cash value in the 20th year of $21,774.00 and which will produce a monthly income of $109.09 also imposes a substantial investment risk upon the respondent? The FFA will thus pay in the 10th year—as a minimum—a monthly income for life which is 90 per cent of that which will be paid by the respondent's conventional annuity; and in the 20th year—as a minimum—an income which is 81 per cent of that which will be paid by the respondent's conventional annuity.

II. As Held in *VALIC* Congress Did Not Intend to Freeze the Concept of the Annuity in Its 1933 Mold.

A. The exemption provisions and their legislative history.

The 1933 Act in Section 3(a)(8) specifically exempts from its coverage any insurance policy, any endowment policy, any annuity contract, or any optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner of any state.[50] The 1940 Act specifically exempts any insurance company, which is defined as a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks under-

50. By November, 1962 the FFA contract had been approved for issuance by the Nebraska Director of insurance and by the insurance commissioners of 16 other states (R. I 35-36).

written by insurance companies, and which is subject to supervision by the insurance commissioner of a state.[51]

Congress made unmistakably certain that Section 3(a)(8) should not be viewed as an ordinary "exemption", but was inserted in the bill to make clear "* * * what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. * * *" Congress was of the view that the "entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible."[52]

In 1944, after the Court removed the supposed Constitutional basis for exemption of insurance by holding that the business of insurance was subject to federal regulation under the commerce power, *United States v. South-Eastern Underwriters Ass'n.*, 322 U. S. 533, congress forthwith enacted the McCarran Act, "broadly to give support to the existing and future state systems for regulating and taxing the business of insurance," *Prudential Insurance Co. v. Benjamin*, 328 U. S. at 429, and "to assure that existing state power to regulate insurance would continue," *Wilburn Boat Co. v. Fireman's Fund Ins. Co.*, 348 U. S. at 319. As Mr. Justice Harlan (dissenting) pointed out in *VALIC*,

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51. The respondent is subject to the supervision of the Nebraska Director of Insurance, the insurance commissioner of the District of Columbia and of 48 other states (R. II 54).

52. H. R. Rep., No. 85, 73rd Cong., 1st Sess. 15 (1933). At the time of the quoted report the House Bill did not contain the words "annuity contract or optional annuity contract," other than by implication in the reference "and like contracts." Simultaneously the Senate was considering S. 875 which specifically mentioned annuity contracts, but did not refer to insurance. The present language, reaching both, was inserted in conference. H. R. 152, 73rd Cong., 1st Sess. (1933). The exemption of insurance reflected not merely adherence to tradition, but also compliance with a supposed command of the Constitution. (Harlan, J., dissenting, 359 U. S. at 97.)

after reviewing the foregoing developments which followed the South-Eastern decision, that decision "rather than encouraging Congress to enter the field of insurance • • • spurred reiteration of its undeviating policy of abstention" 359 U. S. at 99.

Congress did not proceed in enacting the 1933 and 1940 Acts on the assumption that the thrust of the state regulation is frozen, or that the concept of insurance or annuities is frozen. As Mr. Justice Harlan (dissenting) said in *VALIC* "As the insurance business develops new concepts the states adjust and develop their controls," 359 U. S. at 101. As we show below, congress was well aware of state regulation of the participating annuity. The FFA is an extension of the concept of the participating annuity. Congress was also well aware in 1933 of the concept of the deferred (or optional) annuity in which the annuitant has the right to terminate the contract on or before maturity and to receive the surrender value thereof. Congress specifically exempted this type of annuity.

State regulation encompasses the use by insurance companies of separate accounts, and every detail of the FFA and of the respondent's business related to FFA is under the watchful eyes of the Director of Insurance of Nebraska and of the similar officials of the other states where the FFA contract has been approved, and of the National Association of Insurance Commissioners.

B. Congress specifically exempted the deferred (optional) annuity contract.

The FFA is an optional annuity contract, that is, a type of deferred annuity contract. The deferred annuity contract has taken the following forms:[53]

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53. Maclean, Life Insurance (4th ed., 1935) 59-67.

(i) *Annuity without return.*

This is the most elementary form of the deferred annuity. The annuitant pays premiums up to a designated age and upon attainment of that age the insurer undertakes to pay the retirement income. There are no cash values or death benefits, and in the event of the death of the annuitant during the deferred period or the income-payment period the contract terminates and no payments are required to be made by the insurer.

(ii) *Annuity with cash refund.*

This is the next most elementary form of the deferred annuity. This contract is similar to the annuity without return except that in the event of the death of the annuitant during the income-payment period, the beneficiary is paid the total of all premiums less the income payments which have been made to the annuitant, without interest. There are no cash values.

(iii) *Annuity with refund.*

This is similar also to the annuity without return except that in the event of the death of the annuitant income payments are continued to the beneficiary until the total income payments made equal the total premiums paid. There are no cash values.

Speaking in 1935, one scholar noted the unpopularity of the foregoing:

> The unpopularity of the regular deferred annuity as a means of provision for old age has led to the development of a special type of deferred annuity known * * * as * * * "retirement annuity".

* * *

> When the retirement age is reached the policyholder usually has the **option** of selecting either the total cash value at that time (**the cash option**) or an annuity. * * * [54]

As a consequence, the "retirement" or "optional" annuity evolved. Unlike the foregoing types, the retirement or optional annuity provides for cash values during the deferred period as the foregoing do not, and the annuitant is given the option to receive a cash value upon termination of the contract. Congress exempted not merely annuity contracts but "optional" [55] (i.e., deferred) annuity contracts. Congress made the choice. The optional (deferred) annuity—equally with the immediate annuity—is exempt from the federal securities laws. Therefore, petitioner's argument, based as it is entirely upon fragmentizing the contract and reaching for jurisdiction only over a portion thereof, is without any support in the very statutory provision relied upon. Petitioner's very argument is vitiated by the congressional exemption for the class of deferred (optional) annuities.

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54. *Id.* at 63-64.

55. In *VALIC* petitioner did not dispute the assertion made in respondent's brief (p. 22):

> * * * In the Securities Act of 1933, § 3(a)(8) refers to the "**optional annuity contract,**" which is merely another term for a **deferred annuity policy** containing the usual provision allowing an annuitant or a beneficiary to **elect** whether to take the **cash surrender value** instead of the **life annuity.** * * *

C. It was not congress' intention to have the exemption for deferred (optional) annuities depend upon the presence of an accumulation rate during the deferred period or upon the nature thereof.

Petitioner urges, as it did in the court below, that the "investment risk", referred to in the Court's *VALIC* decision means exclusively the risk of respondent's not earning interest on the amounts of net premiums received by the respondent. It is petitioner's contention that an annuity contract can not be an "insurance product" within the meaning of *VALIC* unless there is an accumulation factor during both the deferred and income payment periods, which factor is a guaranteed interest rate. In essence, as the court below observed, petitioner seeks to "freeze" annuity policies to their present conventional form (R. I. 113), and to allow no deviation therefrom. The FFA embodies an evolution of the deferred (optional) annuity conconcept. Its single essential deviation lies in the nature of the accumulation factor during the deferred period.

But any obligation of the insurer to improve net premiums during the deferred period by a guaranteed interest factor is a matter of *contract* not a requirement of law. There is no requirement under the law of any state that there be such an interest factor. In fact, historically, many annuities did not [56] contain such a promise of incre-

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56. E. W. Patterson, Legal Protection of Private Pension Expectations (1960), points out (p. 143):

> * * * The three principal objectives of regulatory legislation [of investments underlying annuities] appear to be those of any well-managed life insurance investment program; safety of principal, yield and liquidity. **Safety of principal is the most important** for the fulfillment of the expectations of the prospective annuitant because of the length of time over which the pay-in stage lasts and also the possible years of the pay-out stage * * * The second objective—yield—is scarcely less important because it adds to the principal and since **most (but not all)** annuity contracts, as well as life insurance contracts, are made with a "guaranteed" minimum yield for every dollar received. * * *

ment. There is, therefore, no basis for freezing the conventional annuity to the extent that there must be such a particular kind of guaranteed accumulation rate during the deferred period.

D. The participating annuity is concededly an insurance product. No intention can be imputed to congress to freeze the form of participation offered. The FFA is, in substance, an evolved form of the participating annuity.

One of the important functions of an insurance company is investment. The passing on to policyholders of favorable investment results [57] achieved by insurance companies has been commonplace for years. In *VALIC* petitioner conceded that annuities issued on a participating basis are not securities. The district court's finding of fact 28 in *VALIC* stated,[58] in part:

> * * * Under participating annuity policy contracts, the amount of the payments to the annuitant may vary due to the declaration by the insurance company of dividends to the annuitant arising from experience more favorable than anticipated with respect to mortality, **investment earnings** and expenses. Plaintiff SEC does not contend, neither has it shown, that it has ever instituted any legal or administrative action charging that annuity policies payable in fixed-dollar amounts issued on a participating basis are "securities" under the Securities Act of 1933, or that the insurance companies issuing such policies are "investment companies" under the Investment Company Act of 1940.

In *VALIC* petitioner had also argued to the Court that the

57. Participating insurance accounted for 64 per cent of all life insurance in force with United States companies at the end of 1965. Life Insurance Fact Book 1966, 21-22.

58. R. 100 in *VALIC*.

dividends on a participating policy may result from favorable investment return.[59]

In *VALIC* the contention was made by petitioner that when congress passed the federal securities laws the variable annuity was unknown—that therefore there was no intention to exempt such form of annuity. But all members of the Court in *VALIC* were of the opinion that there was no congressional intention to "freeze" the forms of insurance (and annuities) into the molds into which they fitted in 1933 and 1940. Congress was indisputably familiar in 1933 and 1940 with participating annuities. No intention may be imputed to congress to "freeze" the development of forms of any annuity contracts including deferred (optional) annuity contracts which offer a participation.

The FFA, while similar in concept in the deferred period to the participating annuity, differs in that in the participating annuity dividends are declared periodically[60] by the board of directors. The FFA guarantees to the annuitant that at the maturity date he will receive the life-

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59. Reply Brief for Petitioner, p. 4:

> It is true that a mutual insurance company or any traditional insurance company writing "participating policies" * * * may distribute dividends in the nature of a return of premium as a result of profitable operations and that these can come about by reason of a favorable investment return, as well as by reason of a favorable mortality experience or lower expenses than anticipated. A mutual policy holder or a holder of a traditional "participating policy," however, like other purchasers of true insurance, is assured of receiving the face amount named in his policy upon the occurrence of the hazard against which he is insured; this is his basic insurance protection. * * *

In the FFA the fixed (guaranteed minimum) values are in effect, the "face amount" named in the policy, that is, the annuitant's basic protection.

60. This is not the case in the FFA. This is one of the reasons why the FFA is technically labelled as "non-participating". In the FFA the respondent makes available to the annuitant automatically the benefit of the respondent's favorable investment experience achieved during the entire deferred period in its investments underlying the FFA.

time income, available not only from fixed[61] (guaranteed minimum) cash value but also from the excess, if any, of the accumulated value over the fixed value. Also, all benefits from any favorable investment experience of the respondent—undiluted by any possible losses resulting from an unfavorable expense and mortality experience—must be passed on to the FFA contractholder. If the respondent modified the FFA by providing that the respondent would at its option upon the maturity date allocate to the FFA some portion of the excess, if any, of the accumulated cash value over the fixed cash value—the contract would then be much less favorable to the annuitant. There would no longer be any obligation on the respondent *automatically* to apply the excess, as now provided. But under petitioner's contention this modification would bring the FFA closer to the conventional participating policy, which is admittedly exempt.

E. Petitioner's basic contention—if accepted—would freeze the annuity concept to its current conventional form.

The Court's decision herein will determine whether the concepts of the deferred (optional) annuity shall remain forever frozen—or whether an insurance company may (without invoking the full arsenal of the federal controls) include in such an annuity contract a method of accounting

61. As an annuity offers greater benefits the premium naturally increases. Thus, the annuity which includes a cash value and a death benefit carries a higher premium than annuities which do not offer such benefits. Conversely, in a participating annuity the amount of the guaranteed income is definitely lower than it would be on a non-participating basis. The FFA contract—as an extension of the principle of participation—does (as should be expected) have lower guaranteed benefits than the conventional annuity, but offers the opportunity to benefit from a greater participation.

for investment results which differs from that heretofore utilized by insurance companies.

There can be little doubt that petitioner contends for the necessity of a guaranteed interest rate in the annuity during the deferred period, in order to exempt it from federal regulation. Petitioner's position is that insurance companies *must* fund all annuities with only debt securities [62] in order to meet the federal test of exemption.

III. The Federal Controls Embodied in the 1933 and 1940 Acts Are Irrelevant to the Respondent and to the FFA and Could Add Nothing to the State Controls, Regulation and Examination Which Exist.

A. The Court held in *VALIC* that where there is some investment risk-taking on the part of the insurer the federal controls are essentially irrelevant.

In *VALIC* petitioner urged upon the Court the proposition that to fall within the insurance exemptions in the federal securities law an insurance company's products had to involve "some" investment risk taking on the part of the company. Petitioner, as well as the intervenor securities trade association, urged upon the Court the proposition that the variable annuity companies were quite similar to investment companies, that they made no guarantees, they merely acted as conduits and remained legally indifferent at all times to the value of their portfolios.

The thrust of the Court's decision in *VALIC* is that where there are some guaranteed fixed dollar benefits then federal controls become essentially irrelevant. It may be inferred from *VALIC* that the Court believed that a mini-

62. Petitioner asserts (Brief, p. 24) that:
* * * the guaranteed yield, and the fixed-return investment required to meet that guarantee, have been the traditional hallmarks of insurance. * * *

mal test was most relevant for applicability of the exemptions in federal law. As Justice Brennan pointed out in *VALIC*, since the variable annuities did not include any specific fixed dollar guarantees federal regulation was quite relevant to that contract. In other words, in the variable annuity the fortunes of the annuitant did turn on the success of the securities market and the investment policy employed. In the FFA there are substantial fixed dollar guarantees, and not the fortunes but merely the possibility of excess benefits resulting from a participating feature is at stake.

B. Petitioner is seeking, in effect, to divest the respondent of control over its investments underlying the FFA contracts.

The very essence [63] of what petitioner is seeking to accomplish in this suit is the transfer of control of respondent's investment policy from respondent itself to FFA contractholders.

It is true that the FFA contractholders, had the courts below granted the relief prayed for by petitioner, indisputably could have appointed forthwith a rival insurance company as their "investment adviser" to control the respondent's investments. Petitioner's contention that the investment policy to be applied to the funds underlying the FFA contracts should be in the hands of others than the respondent is a bit startling. It is respondent alone which undertakes contractual obligations in the FFA to pay substantial guaranteed dollar amounts. It is respondent alone, of course, which must have full control of its investment policy in fulfilling these obligations. At all times the re-

63. In the court below petitioner observed that the provisions of the 1940 Act dealing with the investment advisers contract and investment policy are "in large part **the very essence** of the 1940 Act." Brief for Appellant, p. 31.

spondent carries on its investment activities obligated to respond to the fixed values of the FFA, as well as obligated—in a practical sense—to produce excess values under the contract. Petitioner's argument would appear to be that there should be federal control of that portion of the investment policy which relates only to the production of excess values. But it seems self-evident that one could hardly divide the respondent's investment decisions and policy into two parts, one part relevant to fixed values and another part relevant to excess values—one controlled by the states and the other controlled by the federal government.

C. Petitioner is seeking, under the guise of irrelevant federal regulation, to become the final arbiter of purely insurance matters which should be solely in the hands of the state commissioners.

In *VALIC* Mr. Justice Brennan posed the question as to what would be the subject matter of federal regulation in the case of an annuity. That question remains a vital and significant one in relation to the FFA and to respondent. Petitioner is attempting to intrude upon the historic and exclusive province of state insurance commissioners. Petitioner seeks to set itself up as the final arbiter, in determining whether an insurance company falls within the exemption provisions of the securities laws, of the following:

(a) whether an annuity must have any kind of accumulation factor during the deferred period;

(b) the precise level of that accumulation factor;

(c) the nature of the participation offered by any participating policy;

(d) the level of participation benefits offered;

(e) the level of premiums for fixed benefits offered in an annuity.

All of the foregoing considerations are matters peculiarly within the competence of the state commissioners. It is inconceivable that the test of whether the federal securities laws apply to an annuity should be made to depend upon one or more of the foregoing factors.

While petitioner has never been given authority to pass on the merits of a particular security, insurance commissioners for years have been involved in controlling the fairness of insurance contracts—including life annuity contracts. If the FFA contractholder desired to obtain the exact fixed monthly income for his life which is provided for by the respondent's conventional annuity he would merely *increase* the amount of his premium for the FFA. Thus, the fact is clear that petitioner seeks authority over the premium level of the FFA policy.

Truly, petitioner is seeking jurisdiction over the respondent and the FFA contracts (during the deferred period) in order to control all of the defendant's insurance operations with regard to the FFA policies. However, we submit, it is not petitioner's function to pass judgment upon either the level of the fixed (guaranteed) minimum values of the FFA, or the level of the possible terminal dividend. It is not the petitioner's function to prognosticate what the accumulated cash values of the FFA will be after many years, or to evaluate either the potential liberality or niggardliness of the terminal dividend, if any, which may be produced by the empiric accumulation factor. These are all matters solely for the judgment of state regulators.

D. Respondent—not the FFA contractholder—is the investor. The FFA contractholder is an annuitant.

The FFA contractholder does not expect that the control of the investments underlying the contract will be turned over to him, for an important aspect of the FFA

to him is the responsibility placed upon respondent to carry on the investment function—just as it does in connection with any other group of contracts.

The concept of profit or gain while meaningful in the case of the owner of a security, has little relevance to the annuitant. He does not know how long he will live after the maturity date, and he has no reasoned basis for expecting "gain". If the FFA did not provide for a cash surrender value, then it would be even clearer that the concept of "gain" is irrelevant to the annuitant since any accumulated cash value in excess of the fixed value would not be available to the annuitant in a lump sum at any time, but would only reflect itself in a higher level of lifetime income. Could it then be said that the annuitant was an "investor" in the stock market?

Petitioner seeks to make an analogy between shares of an investment company and the FFA. But no analogy exists. In an investment company the shareholder acquires an equity interest in the assets of the corporation—these assets consist mainly of securities issued by other corporations. The shareholder may, therefore, be quite accurately described as the owner of a *pro rata* share of a portfolio of securities. The investment company stands at all times legally indifferent to the value of the portfolio, and the value of the investor's share depends directly upon the values of the portfolio of securities. The net asset value of such shares is computed twice daily because it is the intention and expectation of the investor to redeem his shares and his decision as to when to redeem will be predicated upon the then value.

In the FFA the respondent does not stand legally indifferent to the values of the investments underlying the FFA. The respondent's investment activities related to the

FFA are carried on in light of its contractual obligations. The values of the investments underlying the FFA determine the excess cash value of the FFA; however, the existence of such excess value and the precise amount thereof is communicated to the annuitant once a year (PX 2, § 11; R. II 3) for informational purposes, as is done with the conventional participating annuity; and not with any intent that the annuitant terminate the contract.

Petitioner did not call any FFA contractholder to testify as to his motivation in acquiring the FFA.[64] Petitioner therefore departs from the record when it makes an argument based directly on the supposed motivations of FFA contractholders (Brief, p. 25). If the record shows anything, it shows that FFA contractholders have every right to believe that they have—over the entire duration of the contract—a contract which guarantees significant fixed benefits and which offers the opportunity for excess benefits.[65]

E. State and federal regulation have different purposes and objectives.

All aspects of the FFA are under state[66] control. Federal controls could only duplicate effective existing state

64. Petitioner assumed this burden in *VALIC* by calling two holders of variable annuities; it decided not to call 8 other policyholders whom it had under subpoena (*VALIC*, R. 375).

65. Petitioner makes reference to certain promotional materials which the respondent used to introduce the FFA in 1962. No such brochure is required under Nebraska law. The FFA can be written without such materials, and the content of any such materials is subject to change or modification. The Nebraska Director of Insurance approved the brochure under his broad statutory powers to prevent misleading advertising. R. R. S. 1943, § 44-1501 *et seq.*

66. Respondent's Answer and the affidavit of N. Murray Longworth (see note 5 above) assert that up to the end of 1963 the FFA had received the approval of the insurance commissioners of 17 states.

control of matters foreign to the expertise of federal regulators. In petitioner's contention the FFA embodies not one but two securities. Petitioner would seek to regulate all aspects of the respondent's operations, particularly its operations which relate to the guaranteed values of the FFA—that, in essence, constitutes *all* of the respondent's operations, since all of the respondent's assets back up its contractual obligations.

Petitioner itself recognizes the different objectives, administration and impact on the public, between the federal regulation of investment companies and the state regulation of insurance companies. Significantly, petitioner also recognizes that it has neither the qualifications [67] nor the personnel,[68] to be involved in insurance regulation.

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67. In Prudential Insurance Company of America, Investment Company Act Release No. 3620, CCH Fed. Sec. L. Rep., ¶ 76,891 (1961-64 Decisions), at p. 81,288 (1963), petitioner said it has "not the qualification, * * * to become involved in matters of insurance regulation."

68. A. F. Conwill [then Director, Division of Corporate Regulation, SEC], Recent Developments Affecting Federal Regulation of Variable Annuity Issuers, The Weekly Underwriter, Feb. 16, 1963, p. 32, points out the limited personnel involved in federal regulation of investment companies:

> May I carry this thought further with an administrative fact of life within the Commission. It may surprise some to learn that the total personnel in my Division devoted to Investment Company Act matters approximates the total number of state insurance commissioners. I mean actual commissioners and not their deputies and subordinates. And when I refer to my personnel I mean the total, including stenographers and clerks. We have no plans for a substantial staff expansion. In fact, for the next fiscal year our budget, if accepted by Congress, will add only three persons to my staff in this area.
>
> The variable annuity problem alone demonstrates the nature of the difficult legal and practical problems with which we are repeatedly confronted. Furthermore, we have 722 registered investment companies for whose regulation we are responsible and whose papers we must process. We must direct an inspection program for these companies.

In view of these circumstances, it is strange to see this administrative agency reaching out for jurisdiction over matters totally foreign to it.

In the case of an annuity a relationship is entered into with the company which may last for 75 years or longer. State regulation of insurance is directed toward such a continuity of relationship and is based upon control of premiums under the contract, the investment policy employed, the existence and size of reserves and the very solvency of the company. This regulation is exercised through detailed and continued examination during the entire duration of the contract. Contrast the petitioner's type of regulation, which is primarily based upon disclosure. It was only in recent years that petitioner undertook the examination of the affairs of the investment companies registered with it and then only a fraction of the companies.[69]

We do not here have a scheme the purpose of which is the realizing of quick profits for promoters, where such scheme should be placed under federal regulation for the protection of the investors. The respondent is fully regulated in every detail of its operation by the various insurance commissioners, and must comply with the laws, administrative regulations and rulings of the states in which

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We have rules to draft and problem areas to study with a view to determining the necessity for future legislation. I say this not in a bureaucratic effort to gain sympathy, but only to inquire—under these circumstances how much insurance regulation could we effectively accomplish even in a single state?

69. In 1957 petitioner initiated a program for the periodic inspection of investment companies pursuant to the statutory authority conferred under Section 31(b) of the 1940 Act. Under this program 52 companies (out of 727 registered under the Act) were inspected in 1962—the year the present suit was commenced. In all prior years only 113 inspections had been made. 28th Annual Report of the Securities and Exchange Commission Fiscal Year Ended June 30, 1962, p. 109.

it does business. It may be noted that no industry, other than the public utility industry, is as well regulated and completely regulated as the insurance industry. *American Hospital and Life Insurance Co. v. Federal Trade Commission*, 5 Cir. 1957, 243 F. 2d 719, aff'd 357 U. S. 560 (1958).

IV. Issuers of Variable Annuities or Investment Company Shares—Unlike the Respondent—Guarantee Nothing Except an Interest in a Portfolio of Common Stocks or Other Equities.

Petitioner persists in this Court in urging two notions which are patently without merit. First, it urges that the respondent's guarantee of the principal sum underlying the FFA contract is "largely without hazard"[70] (Brief, p. 38). Second, it urges that the FFA contractholder is like the investor in *VALIC* or the mutual fund shareholder (Brief, p. 30). The record herein—as well as common sense—completely belies this alleged "likeness".

The holder of a variable annuity or an investment company shareholder is at all times at the mercy of values based directly on the market action of a portfolio of securities—his "fortunes" depend on market action. The issuer of the variable annuity and the investment company too, are legally indifferent to the value of the securities in

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70. Compare the view expressed in *VALIC* in this Court by one of the *amici* herein. The Brief for National Association of Securities Dealers Inc. asserted (p. 24)

> The "variable annuitant" always bears the risk of loss. The respondents do not take any part of that risk: like managers of investment companies, they are without legal responsibility to the "variable annuitants" for any investment, reasonably prudent when made, that happens suddenly to go bad. They cannot be held accountable for any losses to "variable annuitants" that stem from sudden drops in equity values caused by war, deflation, executive heart attacks, or any of a thousand other unforseeable events that affect security values.

the portfolio; they are mere conduits. The respondent, by contrast, undertakes significant and subsisting obligations in the FFA policy, obligations which are legally fixed at the moment of issuance of the policy. There is a true underwriting of risks.[71]

The essential nature of the FFA contract is highlighted by the example of a male, age 35, who pays $100 a month for 10 years in connection with: (a) a variable annuity, as in *VALIC*, (b) investment company shares, and (c) the respondent's FFA:

(a) If he purchases the variable annuity, at the end of the deferred period the guaranteed cash value of the variable annuity will be 0; the contractually guaranteed death benefit will be 0; and during the income-payment period the amount of guaranteed fixed dollar monthly installments will be 0.

(b) If he purchases shares of an investment company to be held till age 45, at the end of the period the guaranteed

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71. The Brief for *Amici Curiae* In Support of Petitioner refers elaborately (pp. 15-17) to the affidavit of D. R. Gustafson, respondent's Actuary in 1963, which was submitted by the respondent in support of its motion for summary judgment. Petitioner has omitted relevant portions of the affidavit including those which state:

> The F.F.A. policy is an annuity policy. The F.F.A. policy involves the identical transfer of risks from the annuitant to the Company as is involved in the case of the Annual Premium Deferred Retirement Annuity policy [the conventional deferred annuity issued by the respondent] * * * The transfer of risks involved in these two types of annuity policies is similar to the transfer of risks from the policyholder to the Company which is involved in the case of whole life policies, as will be more fully shown below (p. 3).
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> * * *
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> * * * The four basic elements of risk transfer are likewise present in the F.F.A. policy. The distinguishing feature of the F.F.A. policy—as compared with the [conventional annuity] policy—is that the transfer of investment risk to the Company takes a different form. * * * (p. 10).

cash value of the shares will be 0; the contractually stipulated death benefit will be 0; and after the 10th year the guaranteed fixed dollar monthly installments, computable from a contractually stipulated table, will be 0.

(c) If he acquires the FFA issued by the respondent, the guaranteed minimum cash value at the end of the deferred period will be $10,374.00; the guaranteed contractually stipulated minimum death benefit will be $12,000; and after the maturity date he will receive each month, as long as he shall live, at least the sum of $42.43.[72]

In the case of the FFA in addition to the *fixed* values noted in the example above, there is the possibility of *excess* values over the deferred period. But the annuitant's "fortunes" will not depend—nor does he acquire a contract that leads him to expect[73] them to depend—upon the existence or non-existence of such excess values. If they are realized, they will be in the nature of a participation, a dividend, or a bonus.

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72. In the example given with a maturity date at age 45, the life expectancy of the annuitant under the applicable table of mortality would be 28.8 years. Thus, the income-payment period would be 3 times as long as the deferred period.

73. In reality the respondent underwrites not merely the most important part of the investment risk during the deferred period (by guaranteeing the principal sum), but *all* of the investment risk provided for by the FFA contract terms. The annuitant's basic protection is premised upon the fixed values; the excess values are stated to be a possible bonus. The FFA stipulates that (PX 2; R. II 2):

> Prior to the Maturity Date the value of this policy **is not guaranteed other than as specifically provided herein**; * * *

The FFA also states (PX 2 § 6; R. II 3):

> Since accumulated values depend upon Accumulation Rates based on the investment experience of Flexible Fund A, such value at the end of any month **may be less than such value at the end of the previous month.**

We think it manifest that the possibility of such a participation over and above significant fixed values in a deferred (optional) annuity was not intended by congress to mark the occasion for the innovation of federal control.

CONCLUSION.

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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